CHAPTER 28

PRICE AND OUTPUT DETERMINATION: MONOPOLISTIC COMPETITION

Pure competition and pure monopoly are the exception, not the rule, in American capitalism. Most market structures fall somewhere between these two extremes. In Chapter 29 we shall discuss oligopoly, a market structure which stands close to pure monopoly. In the present chapter we are concerned with monopolistic competition. Monopolistic competition correctly suggests a blending of monopoly and competition; more specifically, monopolistic competition involves a very considerable amount of competition with a small dose of monopoly power intermixed.

Our basic objectives in this chapter are:

1. To define and discuss the nature and prevalence of monopolistic competition.

2. To analyze and evaluate the price-output behavior of monopolistically competitive firms.

3. To explain and assess the role of non-price competition, that is, competition based upon product quality and advertising, in monopolistically competitive industries.

CONCEPT AND OCCURRENCE OF MONOPOLISTIC COMPETITION

First of all, let us recall, and also expand upon, the definition of monopolistic competition.

Monopolistic competition refers to that market situation in which a relatively large number of small producers or suppliers are offering similar but not identical products. The contrasts afforded with pure competition are important. Monopolistic competition does not require the presence of hundreds or thousands of firms but only a fairly large number—say 25, 35, 60, or 70. Several important characteristics of monopolistic competition follow from the presence of relatively large numbers. In the first place, each firm has a relatively small percentage of the total market, so each has a very limited amount of control over market price. Then, too, the presence of a relatively large number of firms also ensures that collusion—concerted action by the firms to restrict output and rig price—is all but impossible. Finally, with a large number of firms in the industry, there is no feeling of mutual interdependence between them; that is, each firm determines its policies without considering the possible reactions of rival firms. And this is a very reasonable way to act in a market in which one's rivals are very numerous. After all, the 10 or 15 per cent increase in sales which firm X may realize by cutting price will be spread so thinly over its 20, 40, or 60 rivals that for all practical purposes the impact upon their sales will be imperceptible. Rivals' reactions can be ignored, because the impact of one firm's actions upon each of its many rivals is so small that these rivals will have no reason to react.

Also in contrast to pure competition, monopolistic competition has the fundamental feature of *product differentiation*. Purely competitive firms produce a standardized product; monopolistically competitive producers turn out variations of a given product. Many firms produce toothpaste, but the product of each differs from its rivals in one or more respects. Indeed, it must be emphasized that product differentiation has more dimensions than are immediately apparent. "Real," or physical, differences involving functional features, materials, design, and workmanship are obviously important aspects of product differentiation. But "imaginary" differences created through advertising, packaging, and the use of trademarks and brand names can be equally significant. Finally, the conditions of sale make for differentiation; the location of a store, the courteousness of its clerks, the firm's reputation for servicing its products, and the availability of credit are all facets of product differentiation.

The significance of product differentiation is basically twofold. On the one hand, despite the presence of a relatively large number of firms, monopolistically competitive producers have limited amounts of control over the prices of their products because of differentiation. Consumers have preferences for the products of specific sellers and *within limits* will pay a higher price to satisfy those preferences. Sellers and buyers are no longer linked at random as in a purely competitive market. On the other hand, the fact that products are differentiated adds a new and complicating factor to our analysis: *nonprice competition.* Because products are differentiated, it can be supposed that products can be varied over time and that the differentiating features of each firm's product will be susceptible to advertising and other forms of sales promotion. In a monopolistically competitive market economic rivalry centers not only upon price but also upon product variation and product promotion.

Entry into monopolistically competitive industries tends to be relatively easy. The fact that monopolistically competitive producers are typically small-sized firms both absolutely and relatively suggests that economies of scale and capital requirements are few. On the other hand, as compared to pure competition, there may be some added financial barriers posed by the need for deriving a product different from one's rivals and the obligation to advertise that product. Existing firms may hold patents on their products and copyrights on their brand names and trademarks, enhancing the difficulty and cost of successfully imitating them.

In short, monopolistic competition refers to industries that comprise a relatively large number of firms, operating noncollusively, in the production of differentiated products. Nonprice competition accompanies price competition. Ease of entry makes for competition by new firms in the long run.

It is difficult to find clear-cut illustrations of monopolistically competitive industries. Many industries which approximate monopolistic competitions also embody one or more characteristics of oligopoly. Table 28–1 contains a group of manufacturing industries which approximate monopolistic competition. Retail stores in larger cities and metropolitan areas are generally monopolistically competitive; grocery stores, gasoline stations, barber shops, dry cleaners, clothing stores, and so forth, operate under conditions similar to those we have described.

PRICE AND OUTPUT DETERMINATION

Let us now analyze the price-output behavior of a monopolistically competitive firm. To facilitate this task we assume initially that the firms in the industry are producing *given* products and are engaging in a *given* amount of promotional activity. Later we shall note how product variation and advertising modify our discussion.

The Firm's Demand Curve

Our explanation is couched in terms of Figure 28–1*a*. The basic feature of this diagram, which sets it off from our analyses of pure competition and pure monopoly, is the elasticity of the firm's individual demand, or sales, curve. The demand curve faced by a monopolistically competitive seller is highly, but not perfectly, elastic. It is much more elastic than the demand curve of the pure

TABLE 28–1. PERCENTAGE OF OUTPUT* PRODUCED BY FIRMS IN SELECTED LOW-CONCENTRATION MANUFACTURING INDUSTRIES, 1958

Industry	Four largest firms	Four next largest firms	Twelve next largest firms
Plywood	19%	9%	14%
Paperboard boxes	17	10	18
Upholstered furniture	14	4	7
Metal house furniture	14	8	16
Costume jewelry	12	6	14
Men's and boys' suits and coats	11	8	13
Wood furniture	9	4	9
Millinery	6	4	9
Dresses	4	3	5
Women's suits, coats, and skirts	4	2	6

* As measured by value of shipments.

Source: Senate Subcommittee on Antitrust and Monopoly, *Concentration Ratios in Manufacturing Industry, 1958* (Washington, D.C., 1962), part I, table 2.

monopolist, because the monopolistically competitive seller is faced with a relatively large number of rivals producing close-substitute goods. The pure monopolist, of course, has no rivals at all. Yet, for two reasons, the monopolistically competitive seller's sales curve is not perfectly elastic as is the purely competitive producer's:

1. The monopolistically competitive firm has a smaller number of rivals.
2. The products of these rivals are close but not perfect substitutes.

Generally speaking, the precise degree of elasticity embodied in the monopolistically competitive firm's demand curve will depend upon the exact number of rivals and the degree of product differentiation. The larger the number of rivals and the weaker the product differentiation, the greater will be the elasticity of each seller's demand curve, that is, the closer the situation will be to pure competition.

The Short Run: Profits or Losses

The firm will maximize its profits or minimize its losses in the short run by producing that output designated by the intersection of marginal cost and marginal revenue, for reasons with which we are now familiar. The representative firm of Figure 28–1*a* produces an output *Q*, charges a price *P*, and is fortunate enough to realize a total profit of the size indicated. But a less favorable cost and demand situation may exist, putting the monopolistically competitive firm in the position of realizing losses in the short run. This is illustrated in Figure 28–1*b*. In the short run the monopolistically competitive firm may either realize an economic profit or be faced with losses.

The Long Run: Break-even

In the long run, however, the tendency is for monopolistically competitive firms to earn a normal profit, that is, to break even. In the short-run profits case, Figure 28–1*a*, we can expect the economic profits to attract new rivals, because entry is relatively easy. As new firms enter, the demand curve faced by the typical firm will fall (shift to the left) and become more elastic. Why? Because each firm has a smaller share of the total demand and now faces a larger number of close-substitute products. This in turn tends to cause the disappearance of economic profits. When the demand curve is tangent to the average-cost curve at the profit-maximizing output, as shown in Figure 28–1c, the firm is just breaking even. Output Q is the equilibrium output for the firm; as Figure 28–1c clearly indicates, any deviation from that output will entail average costs which exceed product price and, therefore, losses for the firm. Furthermore, economic profits have been competed away, and there is no incentive for additional firms to enter. In the short-run losses case, Figure 28–1b, we can expect an exodus of firms to occur in the long run. Faced with fewer substitute products and blessed with an expanded share of total demand, surviving firms will find that their losses disappear and gradually give way to approximately normal profits.[1]

Note that we have been very careful in designating our long-run analysis as a statement of a tendency. The representative firm in a monopolistically competitive market *tends* to break even in the long run. There are certain complicating factors which prevent us from being more dogmatic. First, some firms may achieve a measure of product differentiation which cannot be duplicated by rivals even over a long span of time. A given gasoline station may have the only available location at the busiest intersection in town. Or a firm may hold a patent which gives it a slight and more or less permanent advantage over imitators. Such firms may realize a sliver of economic profits even in the long run. Second, remember that entry is not completely unrestricted. Because of product differentiation, there are likely to be greater financial barriers to entry than otherwise would be the case. This again suggests that some economic profits may persist even in the long run. A third consideration may work in the opposite direction, causing losses—below-normal profits—to persist in the long run. The proprietor of a corner delicatessen persistently accepts a return less than he could earn elsewhere,

[1] For simplicity's sake we assume constant costs; shifts in the cost curves as firms enter or leave would complicate our discussion but not alter the conclusions.

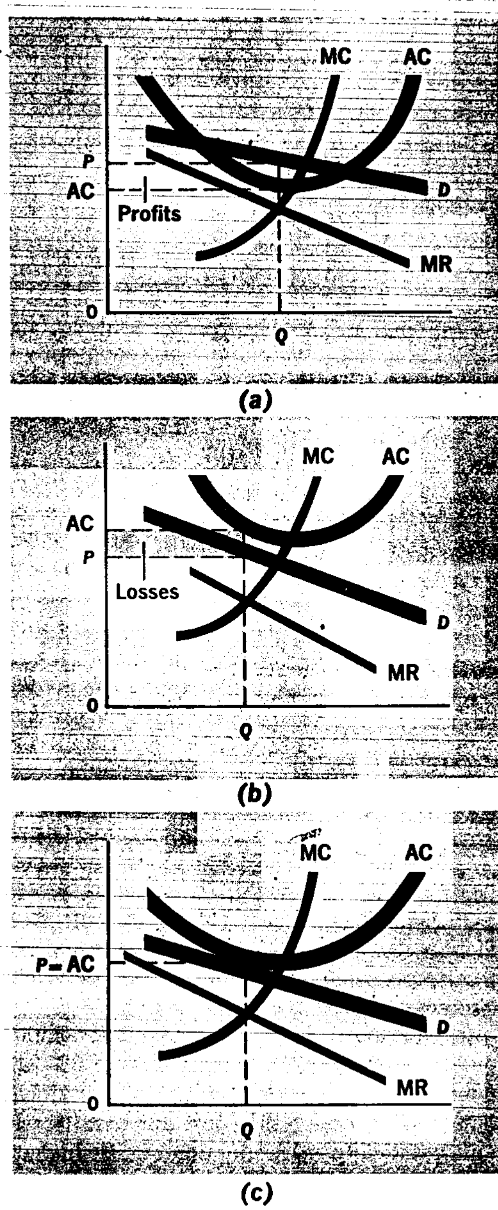


FIGURE 28–1. MONOPOLISTICALLY COMPETITIVE FIRMS TEND TO REALIZE A NORMAL PROFIT IN THE LONG RUN.

The economic profits shown in (*a*) will induce new firms to enter, causing the profits to be competed away. The losses indicated in (*b*) will cause an exodus of firms until normal profits are restored. Thus in (*c*), where price just covers unit costs at the MR = MC output, the firm's long-run equilibrium position is portrayed.

because his business is a way of life to him. The suburban barber ekes out a meager existence, because cutting hair is "all he wants to do." With all things considered, however, the long-run profitless equilibrium of Figure 28–1*c* is probably a reasonable portrayal of reality.

WASTES OF MONOPOLISTIC COMPETITION

Recalling our evaluation of competitive pricing in Chapter 26, we know that economic efficiency requires the triple equality of price, marginal cost, and average cost. The equality of price and marginal cost is necessary for a correct allocation of resources to the product. The equality of price with minimum average total cost entails the use of the most efficient (least-cost) technology; this equality means that consumers will enjoy the largest volume of product and the lowest price which prevailing cost conditions will allow.

An examination of Figure 28–1*c* suggests that the monopolistic element in monopolistic competition causes a modest underallocation of resources to goods produced under this market structure. Price exceeds marginal cost in long-run equilibrium, thereby indicating that society values additional units of this commodity more than the alternative products which the needed resources can otherwise produce.

Furthermore, in contrast to purely competitive firms, as suggested in Figure 28–1*c*, monopolistically competitive firms produce somewhat short of the most efficient (least unit cost) output: Production entails higher unit costs than the minimum attainable. This in turn means a somewhat higher price than would result under pure competition. Consumers do *not* benefit from the largest output and lowest price which cost conditions permit. Indeed, monopolistically competitive firms must charge a higher than competitive price in the long run in order to manage a normal profit. Looked at differently, if each firm were able to produce at the most efficient output, a smaller number of firms could produce the same total output, and the product could be sold to consumers at a lower price. Monopolistically competitive industries tend to be overcrowded with firms, each of which is underutilized, that is, operating short of optimum capacity. This is typified by retail establishments, for example, the highway intersection adorned with four gleaming gasoline stations all operating far short of capacity. Underutilized plants, consumers penalized through higher than competitive prices for this underutilization, and producers just making a normal return in the long run—these are the so-called "wastes" of monopolistic competition.

But we must not be hypercritical of monopolistic competition. Some economists argue that in many monopolistically competitive industries the price and output results are not drastically different from those of pure competition. The highly elastic nature of each firm's demand curve guarantees that the results are nearly competitive. Furthermore, it must be kept in mind that any deviations from the purely competitive output and price may be offset by the fact that with monopolistic competition the consumer now can choose from a variety of products; he is not faced with a homogeneous commodity.

NONPRICE COMPETITION

For reasons cited above, we can conclude that the situation portrayed in Figure 28–1*c* may not be particularly beneficial to society. It can also be surmised that it is not very satisfying to the monopolistically competitive producer who barely captures a normal profit for his efforts. We can therefore expect monopolistically competitive producers to take steps to improve upon the long-run equilibrium position. But how can this be accomplished? The answer lies in product differentiation. Each firm has a product which is currently distinguishable in some more or less tangible way from those of his rivals. The product is assumedly subject to further variation, that is, to product development. Then, too, the emphasis of real product differences and the creation of imaginary differences may be achieved through advertising and related sales promotion. In short, the profit-realizing producer of Figure 28–1*a* is loath to stand by and watch new competitors encroach upon his profits by duplicating or imitating his product, copying his advertising, and matching his services to consumers. Rather, he will attempt to sustain these profits and "stay ahead" of competitors through further product development and by enhancing the quantity and quality of advertising. In this way he might prevent the long-run tendency of Figure 28–1*c* from becoming a reality. True, product development and advertising will add to the firm's costs. But they can also be expected to increase the demand for his product. If demand increases by more than enough to compensate for development and promotional costs, the firm will have improved its profit position. As Figure 28–1*c* suggests, the firm may have little or no prospect of increasing profits by price cutting. So why not practice nonprice competition?

Product Differentiation and Product Development

The likelihood that easy entry will promote product variety and product improvement is possibly a redeeming feature of monopolistic competition which may offset, wholly or in part, the "wastes" associated with this market structure. There are really two somewhat distinct considerations here: (1) product differentiation at a point in time and (2) product improvement over a period of time.

1. Product differentiation means that at any point in time the consumer will be offered a wide range of types, styles, brands, and quality gradations of any given product. As compared with the situation under pure competition, this correctly suggests possible advantages to the consumer. His range of free choice is widened, and variations and shadings of consumer tastes are more fully met by producers. But skeptics warn that product differentiation is not an unmixed blessing. Product proliferation may reach the point where the consumer becomes confused and rational choice is highly unlikely. Variety may add spice to the consumer's life, but only up to a point. Worse yet, some observers fear that the consumer, faced with a myriad of similar products, may rely upon such a dubious expedient as judging product quality by price; that is, the consumer may irrationally assume that price is an index of product quality.

2. Product competition is an important avenue of technological innovation and product betterment over a period of time. Such product development may be cumulative in two different senses. (*a*) A successful product improvement by one firm obligates rivals to imitate or, if they can, improve upon this firm's temporary market advantage or suffer the penalty of losses. (b) Profits realized from a successful product improvement can be used to finance further improvements. Again, however, there are notable criticisms of the product development which may occur under monopolistic competition. Critics point out that many product alterations are more apparent than real, consisting of frivolous and superficial changes in the product which do not improve its durability, efficiency, or usefulness. A more exotic container, bright packaging, or "shuffling the chrome" are frequently the focal points for product development. It is argued, too, that particularly in the cases of durable and semidurable consumer goods, development seems to follow a pattern of "planned obsolescence," wherein firms improve their product only by that amount necessary to make the average consumer dissatisfied with last year's model.

Do the advantages of product differentiation, properly discounted, outweigh the "wastes" of monopolistic competition? It is difficult to say, short of examining specific cases, and even then concrete conclusions are difficult to come by. For example, a recent study of the (oligopolistic) automobile industry attempts to measure the cost of model changes in recent years.[2] Specifically, this question was posed: What has been the aggregate annual cost of the increases in automobile size, increases in horsepower, increased gasoline consumption caused by the "horsepower race," "power" accessories, and the cost of factory retooling required by such model changes? The investigators concluded that "the estimated costs of model changes since 1949 . . . run about 5 billion dollars per year over the 1956–60 period. . . ." Thus, although there is no question that the automobile today is a better product than it was in 1949, it is nevertheless quite legitimate to inqure: Is it *that much* better?

Advertising

A monopolistically competitive producer may gain at least a temporary edge on his rivals by manipulating his product. He may achieve the same result by manipulating the consumer through advertising and sales promotion. While product differentiation adapts the product to consumer demand, advertising adapts consumer demand to the product. In practice these two aspects of nonprice competition may be difficult to disentangle. Does a new and colorful method of packaging a product constitute a change in the product, or is it a means of advertising and promotion?

Though we might tentatively agree that product development is a desirable feature of monopolistic competition, the advertising which accompanies it is more difficult to evaluate. The social desirability of extensive advertising expenditures is a very controversial and clouded topic. A basic reason for this is the fact that some advertising is *informative*, that is, accurately descriptive of the qualities and prices of products, while other advertising is *competitive*, consisting of unsubstantiated ours-is-better-than-theirs exhortation. Local newspaper advertising is informative; the cigarette and soap advertisements that the television industry funnels into American living rooms are competitive.

This controversy is not an unimportant one. Currently advertising and promotional expenditures in American capitalism have been about $14 billion per year. This is roughly equal to the nation's annual outlay on primary and secondary public education. Hence, if advertising is generally wasteful, any potential virtues of monopolistically competitive markets are thereby dimmed, and the need for corrective public policies is indicated.

Extreme arguments are prevalent. Some economists are prone to write off all advertising as sheer economic waste. Others—the admen themselves—manage to associate all that is just and good in American society with advertising. An accurate picture lies in the middle ground. Let us survey the basic claims for and the charges against advertising.

The case for advertising. Some of the arguments in favor of advertising follow:

1. Advertising allegedly provides the information which assists consumers in making rational choices. In a dynamic, complex economy there is an acute need for the consumer to be closely acquainted with new firms, new products, and improvements in existing products. Advertising is the medium which disperses such information.

2. Advertising supports national communications. Radio, television, magazines, and newspapers are supported wholly or in part through advertising.

3. It has been argued more recently that advertising is a stimulant to product development. Successful advertising is frequently based upon unique and advantageous features of a firm's product. Hence, a firm is obligated to improve its product to provide "sales points" for competing successfully in the advertising sphere.

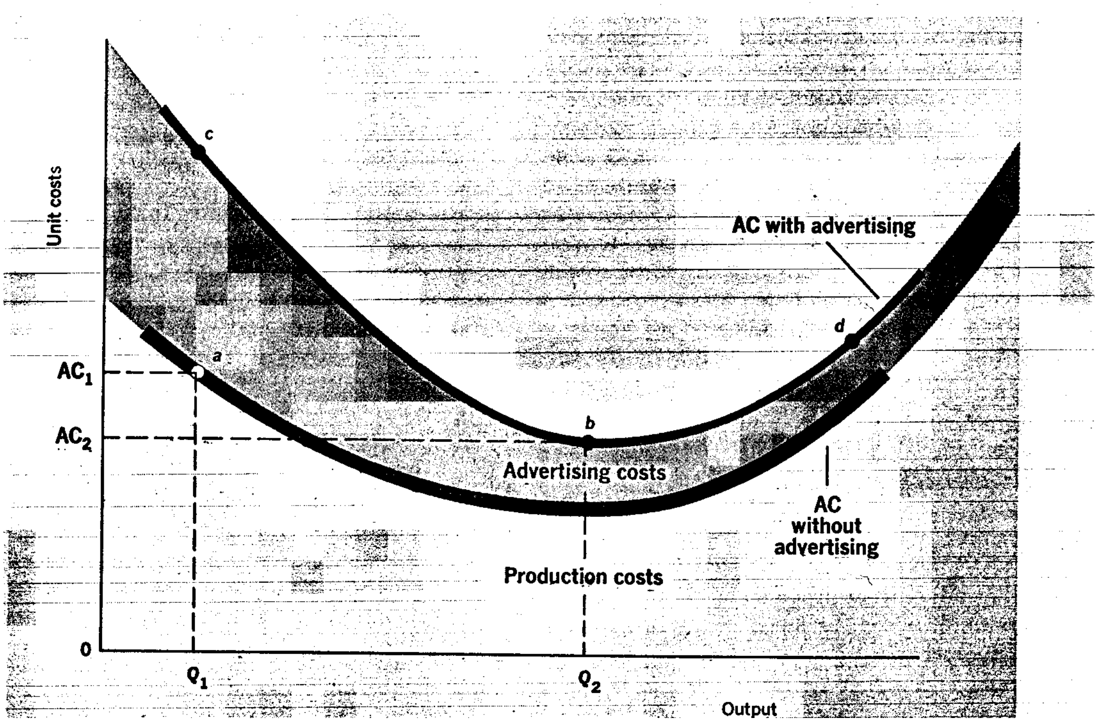
[2] F. M. Fisher, Z. Griliches, and C. Kaysen, "The Costs of Automobile Model Changes since 1949," *Journal of Political Economy*, October, 1962, pp. 433–451.

4. Through successful advertising a firm can expand its production and thereby realize greater economies of scale. As shown in Figure 28–2, by shifting the firm's demand curve to the right through advertising, production will expand from, say, Q_1 to Q_2. Despite the fact that advertising outlays will shift the firm's average-cost curve upward, unit costs will nevertheless decline from, say, AC_1 to AC_2. Greater productive efficiency resulting from economies of scale more than offsets the increase in unit costs due to advertising. Consumers will therefore get the product at a lower price with advertising than they would in its absence.

5. It is also contended that advertising promotes full employment by inducing high levels of consumer spending. This is particularly crucial, it is argued, in a wealthy society such as that of American capitalism, where much of total production takes the form of luxury or semiluxury goods which fulfill no basic wants. One need not advertise to sell food to a hungry man, but advertising and sales promotion are essential in persuading families that they need a

FIGURE 28–2. THE POSSIBLE EFFECTS OF ADVERTISING UPON A FIRM'S OUTPUT AND AVERAGE COSTS.

Proponents of advertising contend that resulting economies of scale will expand the firm's production from, say, *a* to *b* and lower unit costs as economies of scale are realized. Some critics argue that advertising is more likely to increase costs and leave output largely unchanged, as is suggested by the movement from *a* to *c*. Others point out that expansion realized through advertising may force diseconomies of scale upon the firm, as the movement from *a* to *d* indicates.



second car, color television, or an automatic dishwasher. Stability in an opulent society calls for want-creating activities—in particular, advertising—or high levels of production and employment will not be sustainable.

The case against advertising. Some of the arguments on the other side of the picture debunk the claims for advertising; others raise new points.

1. Critics of advertising point out that the basic objective of advertising is to persuade, not to inform. Competitive advertising is based upon misleading and extravagant claims which serve to confuse and frequently insult the intelligence of the consumer, not enlighten him. Little of real value in the rendering of rational choices can be garnered from the soap and cigarette advertising which crowds our television screens and adds bulk to our slick magazines. Indeed, advertising may well persuade consumers in some cases to pay high prices for much-acclaimed but inferior products, forgoing better but unadvertised products selling at lower prices. The Pure Food and Drug and Federal Trade Commission Acts, which are aimed at protecting consumers from product misrepresentation and misleading advertising, testify as to past and present abuses by modern-day hucksters.

2. Advertising expenditures as such are relatively unproductive; they add little or nothing to the well-being of society. Advertising diverts human and property resources from other, more pressing areas. For example, lumber which is sorely needed in the production of low- and medium-priced housing is squandered on the construction of unsightly billboards. In short, advertising gives rise to a gross misallocation of resources.

In recent years the general criticism that advertising promotes a misallocation of resources has assumed a special form: advertising allegedly contributes to *social imbalance*. That is, advertising, in conjunction with a number of other considerations, has given rise to the overproduction of private goods relative to public or social goods. It is argued that advertising is peculiar to, and an integral part of, the production and sale of private goods. Gigantic advertising campaigns extoll the merits of electric can openers, self-propelled lawnmowers, and eight-speaker stereophonic phonographs. But no similar force proclaims the virtues of social goods and services; similar persuasion does not exist to whet the consumer's appetite for better schools, improved streets and highways, increased expenditures for medical research, and so forth. The net result, it is contended, is a misallocation of resources; resources are overallocated to private goods and underallocated to public goods. Private goods are superabundant; the quantity and quality of social goods are remarkably deficient. The problem of social imbalance will be pursued at length in Chapter 38.

3. Significant social costs are entailed by advertising. Billboards blot out roadside scenery and generally debase the countryside. Sound trucks disrupt suburban serenity. Of potentially greater importance are the effects which advertising's support of national communications may have upon the accuracy and quality of those communications. Will a newspaper present an unprejudiced report of the labor dispute in which its major advertiser is involved? Will a television newscast conveniently ignore the fact that antitrust action has been initiated against its sponsor? Will a firm which distributes its product nationally permit the television playhouse it sponsors to present an honest and frank portrayal of the integration problem? In more general terms, it is charged that competitive advertising offends the common sense and tries the patience of society. The fact that water consumption rises enormously during television commercials adds credulity of this latter contention.

4. Critics of advertising are very dubious of the argument that advertising permits firms to expand, to achieve lower unit costs, and to offer their products at lower prices to consumers. Reasons for this doubt are several. First, it is contended that advertising

tends to be self-canceling. The million-dollar advertising campaign of one cigarette manufacturer is largely offset by equally expensive campaigns waged by its rivals. Few additional people smoke cigarettes. Each firm has about the same portion of the market as it had originally. And the cost, and therefore the price, of cigarettes is higher. In Figure 28–2 self-canceling advertising may move the firm from point *a* to point *c*, not from *a* to *b*. Second, if advertising can cause a firm to realize economies of scale through growth, can it not also cause a firm to encounter diseconomies? Might not advertising shift the firm's level of output from point *a* to point *d* in Figure 28–2? Third, are there not more desirable and less costly alternative means by which a firm might expand output and achieve economies of scale? Would not product development or research on productive methods permit a firm to achieve economies of scale and at the same time avoid the upshift in its average-cost schedule which advertising entails? Finally, even if a firm achieves lower units costs through advertising, will the consumer benefit through proportionate price reductions? This point is particularly pertinent in view of the fact that the expansion of those firms whose advertising is most successful implies that less successful advertisers will fall by the wayside, causing the industry to move away from monopolistic competition and in the direction of oligopoly, wherein firms have greater control over product price.

5. Most economists are reluctant to accept advertising as an important determinant of the levels of output and employment. There has been little evidence of economic stagnation in the postwar years that would seem remediable by advertising and promotional outlays. Furthermore, the most volatile aspect of aggregate demand is not so much highly advertised consumer goods as it is little-advertised investment goods. The consensus seems to be that advertising probably affects the composition more than it does the volume of spending. And those economists who do accept the contention that advertising now has an impact upon consumer spending suggest that at some future time its effect on the level of spending may diminish to zero.[3]

> On some not distant day, the voice of each individual seller may well be lost in the collective roar of all together. Like injunctions to virtue and warnings of socialism, advertising will beat helplessly on ears that have been conditioned by previous assault to utter immunity. . . . It will be worth no one's while to speak, for since all speak none can hear.

At this point an economy whose level of spending is supported by effective advertising will be plagued by serious instability. If consumer wants and consumer spending are contrived through advertising, the future failure of that contrivance could materially contribute to recession and unemployment.

At least one critic has contended that advertising expenditures are procyclical, that is, they fluctuate *with* total spending, intensifying unemployment during bad times and adding to inflationary pressures during prosperous times.[4]

6. There is evidence that in some industries advertising has become such a large part of the cost of doing business that it constitutes an important financial barrier to entry. This is generally recognized to be the case in the cigarette industry, where producers as a group may spend considerably in excess of $150 million per year on advertising and related promotional activities.

Where do these arguments and counterarguments leave us? Certainly without a clear-cut conclusion. However, even though both cases are interspersed with partial truths and arguments that are valid in specific instances but not generally, we are at least in a better position to form a personal judgment upon the social worth of adver-

[3] John K. Galbraith, *The Affluent Society* (Boston: Houghton Mifflin Company, 1958), p. 202.
[4] Alvin H. Hansen, *Economic Issues of the 1960's* (New York: McGraw-Hill Book Company, 1961), p. 36.

tising.[5] This much can be ventured: Most economists are inclined to conclude that the consumer benefits much more from nonprice competition in the form of product development than he does from advertising.

Monopolistic Competition and Economic Analysis

Our discussion of nonprice competition correctly infers that the equilibrium situation of a monopolistically competitive firm is actually much more complex than the previous graphic analysis indicates. Figure 28–1*a*, *b*, and *c* *assumes* a given product and a given level of advertising expenditures. But, alas, these we now know are not given in practice. The monopolistically competitive firm must actually juggle three variable considerations—price, product, and promotion—in seeking maximum profits. What specific variety of product, selling at what price, and supplemented by what level of promotional activity will result in the greatest level of profits attainable? This complex situation is not readily expressed in a simple, meaningful economic model. At best we can note that each possible combination of price, product, and promotion poses a different demand and cost (production plus promotion) situation for the firm, some one of which will allow him maximium profits. In practice, this optimum combination cannot be readily forecast but must be sought by the process of trial and error. And even here certain limitations may be imposed by the actions of rivals. A firm may not risk the elimination of advertising expenditures for fear his share of the market will decline sharply to the benefit of his rivals who do advertise. Similarly, patents held by rivals will rule out certain choice product variations.

[5] The student who feels compelled to pursue this controversy should compare Vance Packard, *The Hidden Persuaders* (New York: David McKay Company, Inc., 1957), and Steuart Henderson Britt, *The Spenders* (New York: McGraw-Hill Book Company, 1960).

DOES MONOPOLISTIC COMPETITION BREED OLIGOPOLY?

Monopolistic competition presumes a relatively large number of independently acting firms producing differentiated products in a market environment into which entry is relatively easy. Many economists feel that there are few industries in modern American capitalism in which these requirements are strictly fulfilled. Further, in those industries in which monopolistic competition does exist, certain dynamic aspects of this market situation tend to push monopolistic competition in the direction of oligopoly. Let us explain these contentions.

1. Many retail industries which outwardly fulfill the conditions of monopolistic competition are actually much more localized than they appear to be. A city may have forty or fifty grocery stores, but each store is only in direct competition with a *few* nearby rivals. Suburban stores do not compete greatly with their downtown counterparts; northside and southside grocers do not compete, and so forth. This means that, although a large number of firms exist, they are usually subdivided into smaller, *interdependent* groups.

2. Combination has caused monopolistic competition to give ground to oligopoly in some important retail industries. For example, vertical integration by large petroleum producers has pushed the oligopolistic structure of the petroleum industry forward to the retail level. Instead of thirty independent gasoline stations, we now have groups of gasoline stations affiliated with, say, four or five different brands of gasoline. Horizontal combinations in the form of chain stores at the retail level have also had the effect of reducing the number of independent firms in the areas of retail automobile supplies, groceries, and drugs. By, in effect, reducing the number of independent firms, these two tendencies give rise to mutual interdependence among sellers—a basic characteristic of oligopoly.

3. Of greatest importance is the belief

that nonprice competition is a dynamic facet of monopolistic competition through which such industries evolve into the less competitive market structure of oligopoly. More specifically, it is argued that product development and advertising simultaneously work to reduce the number of firms in monopolistically competitive industries and to create entry barriers which discourage their replacement by new firms. This merits some explanation.

Product differentiation and development can lead to significant entry barriers over time. This is particularly pertinent because product development is likely to be cumulative; that is, a firm which gains a temporary advantage over its rivals through a successful change in its product can employ the resulting profits to finance the research needed to widen that advantage. Temporary product advantages have a tendency to become permanent, to the end that less alert or less fortunate rivals fall by the wayside. All this is reinforced when product variations are significant enough to result in patent and copyright protection. Similarly, if the fruits of successful product variation are used to finance the development of more efficient productive techniques, the resulting economies of scale and lower unit costs provide a basis for eliminating high-cost rivals and restricting the entry of new firms.

Advertising may also reduce the number of firms in a monopolistically competitive industry over a span of time. In a few instances some firms may simply "out-advertise" and thereby eliminate their rivals. On the other hand, if the advertising campaigns of monopolistically competitive rivals are largely self-canceling between firms and have little impact upon industry demand, the rising unit costs attributable to advertising may press upon price and eliminate the least efficient firms. Or possibly this price-cost squeeze will precipitate aggressive price cutting—a price war—which will have substantially the same effect. Finally, we have already noted that large advertising budgets can pose a substantial barrier to entry, thereby also undermining a basic characteristic of monopolistic competition.

If these arguments are reasonably accurate, we can conclude that the basic reasons for studying the behavior of monopolistically competitive industries are:

1. A knowledge of such industries provides important information concerning the evolution and growth of oligopoly.

2. Many industries in American capitalism blend features of both monopolistic competition and oligopoly.

It is with oligopolistic markets that the next chapter is concerned.

SUMMARY

1. The distinguishing features of monopolistic competition are: **a.** There is a large enough number of firms so that each has little control over price, mutual interdependence is absent, and collusion is virtually impossible; **b.** products are characterized by real and imaginary differences and by varying conditions surrounding their sale; and **c.** entry to the industry is relatively easy. Many aspects of retailing, and some industries wherein economies of scale are few, approximate monopolistic competition.

2. Monopolistically competitive firms may earn economic profits or incur losses in the short run. The easy entry and exodus of firms gives rise to a long-run tendency for them to earn a normal profit.

3. The long-run equilibrium position of the monopolistically competitive producer is less socially desirable than that of a purely competitive firm. Under monopolistic competition price exceeds marginal cost, suggesting an underallocation of resources to the product, and price exceeds minimum average total cost, indicating that consumers do not get the product at the lowest price which cost conditions would allow. However, because the firm's demand curve is highly elastic, these "wastes" of monopolistic competition should not be overemphasized.

4. Product differentiation provides a means by which monopolistically competitive firms can offset the long-run tendency for economic profits to approximate zero. Through product development and advertising, a firm may strive to increase the demand for its product more than nonprice competition increases its costs.

5. Although subject to certain dangers and problems, product differentiation affords the consumer a greater variety of products at any point in time and improved products over time. Whether these features fully compensate for the wastes of monopolistic competition is a moot question.

6. There is sharp disagreement as to the economic benefits of advertising. Proponents justify advertising on the grounds that it **a.** aids consumers in exercising rational choices, **b.** supports national communications, **c.** speeds product development, **d.** permits firms to realize economies of scale, and **e.** encourages spending and a high level of employment. Critics assert that advertising **a.** confuses rather than informs, **b.** misallocates resources away from more urgent employments (particularly from the production of social goods), **c.** involves a variety of social costs, **d.** results in higher, not lower, costs and prices, **e.** is not a strategic determinant of spending and employment, and **f.** often constitutes a significant financial barrier to entry.

7. In practice the monopolistic competitor seeks largely through trial and error that specific combination of price, product, and promotion which will maximize his profits.

8. There is evidence to suggest that monopolistically competitive market situations tend to give way to oligopoly. Product development and advertising may well tend to eliminate existing firms and create barriers to the entry of new ones. Vertical and horizontal combination and the localized nature of retail markets have tended to undermine monopolistic competition in retailing.